

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

**FOR
AGENDA**

SM/94/292 ,
Supplement 1

CONTAINS CONFIDENTIAL
INFORMATION

January 18, 1995

To: Members of the Executive Board
From: The Acting Secretary
Subject: Sweden - Staff Report for the 1994 Article IV Consultation

The attached supplement to the staff report for the 1994 Article IV consultation with Sweden (SM/94/292, 12/9/94) has been prepared on the basis of additional information.

Mr. Lachman (ext. 36223) or Mr. Ramaswamy (ext. 38591) is available to answer technical or factual questions relating to this paper prior to the Board discussion, scheduled for Friday, January 20, 1995.

Unless the Documents Preparation Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the GATT Secretariat and the Organisation for Economic Cooperation and Development (OECD), following its consideration by the Executive Board.

Att: (1)

Other Distribution:
Department Heads

SECRET

IN THE MATTER OF THE EVIDENCE OF THE

100-100000

100-100000

100-100000

100-100000

100-100000

100-100000

The attached document is a copy of the report of the

Mr. [Name] and [Name] of the [Name] and [Name] of the [Name]

Unless the document is a copy of the report of the [Name] and [Name] of the [Name]

(1)

Other Distribution
Department Head

INTERNATIONAL MONETARY FUND

SWEDEN

Staff Report for the 1994 Article IV Consultation
Supplementary Information

Approved by Michael C. Deppler and Jan F. van Houten

January 18, 1995

1. Since early November 1994, there have been a number of important economic developments in Sweden. These include Sweden's entering the European Union on January 1, 1995; the downgrading of Sweden's public sector debt by a number of credit rating agencies; and the introduction of a budget for the 18-month period June 1995 to December 1996. Developments in these areas were largely anticipated at the time of the 1994 Article IV consultation discussions in Stockholm and they do not occasion a change in the appraisal of the staff report. However, they do add urgency to the need to strengthen the medium-term fiscal consolidation plan in a manner that might restore the conditions for sustaining the economic recovery presently underway.
2. On November 13, 1994, the Swedish electorate voted in favor of Sweden joining the European Union. On November 23, 1994, Parliament made the necessary amendments to the constitution and on January 1, 1995 Sweden acceded to EU membership. While the Riksbank has signed the agreement on the European Monetary System, the authorities have publicly stated that Sweden will not apply for participation in the Exchange Rate Mechanism (ERM) before redressing the underlying imbalances in the economy. The estimated annual budgetary cost of EU membership is around SKr 20 billion, or 1 1/3 percent of GDP, but it is anticipated that EU membership would allow reductions in other budgetary expenditures of around SKr 6 billion. The overwhelming proportion of the budgetary cost of membership is to be financed through tax measures that would further add to Sweden's already high tax burden. Among the tax measures proposed are a 1 1/2 percent increase in the employers' contribution to the social security payroll tax; various taxes on agricultural and commercial property; and a variety of environmental and energy taxes.
3. On January 8, 1995, Moodys downgraded Sweden's public credit rating from Aa2 to Aa3, thereby following the earlier similar downgrading by ICBA, the European credit rating agency. This places Sweden's credit rating below that of the other Nordic countries, Ireland, and Spain, but leaves it one notch above Italy's credit rating. Moodys cited the large fiscal deficit and the increased public debt as reasons for the downgrading. On

January 12, 1995 Standard and Poor revised the outlook for Sweden's foreign currency rating to negative from stable, even though the rating itself was, not downgraded from the existing AA+.

4. On January 10, 1995, the Government presented a Budget Bill that covers the 18-month period June 1995 to December 1996. As anticipated in the November 1994 Economic Policy Statement, the Budget Bill proposes spending cuts totaling SKr 21.7 billion, or 1 1/2 percent of GDP, by 1998. However, these spending cuts are not fully specified and are relatively backloaded as indicated by the fact that spending cuts totaling only SKr 7.5 billion, or 1/2 percent of GDP, are to take effect in the 12-month period 1995/96. The proposed spending cuts are spread across a wide range of ministries, with important cuts totaling SKr 8.4 billion by 1998 in the Ministry of Health and Social Affairs. The main savings in the latter respect are to come from reduced child allowances in 1996 and from a reduction in the replacement rate to 75 percent in 1997 for sick leave and for parental leave.

5. Accompanying the January 1995 Budget Bill was a comprehensive action program for promoting business sector employment, raising the general level of education, and supporting the labor market's most vulnerable groups. The implementation of this temporary employment stimulus program was estimated to raise central government spending by SKr 9.2 billion, or over 1/2 a percentage point of GDP, in the 12-month period 1995/96. While the Government intends to finance this additional spending by yet to be specified one-off measures, there is the added concern that it might not be easy to get rid of these programs.

6. The authorities have revised upwards their medium-term estimates of the overall public sector deficit on the basis of the budget measures now proposed and in anticipation of higher borrowing costs than were earlier estimated. On the assumption that real GDP were to increase by 2 1/2 percent in 1995 and by an average 2.7 percent between 1996 and 1998, the authorities are now projecting that the overall public sector deficit would remain at over 10 percent of GDP in 1995 before it would decline progressively to 2 1/2 percent of GDP by 1998 (Table 1). The higher public deficit that is now being projected would result in the gross public debt to GDP ratio stabilizing at somewhat over 100 percent by 1997 under the revised official forecast.

7. In conjunction with the January 1995 Budget Bill, the Government has proposed that the National Debt Office be authorized to borrow in foreign currency at least SKr 30 billion, or around US\$4 billion, in 1995. Since foreign currency loans to the government totaling SKr 60 billion mature in 1995, this implies a gross external borrowing requirement for the National Debt Office of around SKr 90 billion, or US\$12 billion in 1995. The National Debt Office is also authorized to increase foreign currency borrowing to a certain extent over these levels if favorable terms are obtainable in the international financial market so that the central government's borrowing costs can be reduced.

8. The initial market reaction to the authorities' budget proposal has not been favorable. Between the beginning of the year and January 16, 1995, interest rates on Swedish 10-year government bonds have risen from under 10 3/4 percent to over 11 percent, representing a 350 basis point spread in relation to comparable German rates. Over the same period, as measured on an ECU index basis, the Swedish krona has depreciated from 122 to 125.

9. The official forecast for real GDP growth has been revised downward to 2.6 percent in 1995 and 2.9 percent in 1996 (Table 2). In large measure, this downward revision reflects a rebasing of the national accounts, which now gives a greater weight to the construction sector. However, it also reflects the adverse impact that high interest rates have had on the incipient recovery in consumer demand in the second half of 1994 and the anticipated effect of budget consolidation on household disposable income. The anticipated growth in the economy is expected to result in a decline in the overall unemployment rate from 13 percent in 1994 to 10.8 percent in 1996. Reflecting the export-led nature of the recovery, Sweden's external current surplus is expected to strengthen further to around 3 1/2 percent of GDP in 1996. Consumer prices, which have shown some tendency to accelerate in 1994 are now officially forecast to increase by 2.9 percent in 1995 and by 3.7 percent, or above the Riksbank's inflation target range, in 1996. Increased indirect taxes and reduced subsidies largely account for the increase in the inflation forecast. The Net Price Index, which excludes the effects of changes in indirect taxes and subsidies, is calculated to rise by less than 2 percent a year in 1995 and 1996.

Table 1. Sweden: Official Medium-Term Public Finance Scenarios 1/
(In percent)

	1994	1995	1996	1997	1998
<u>I. November 1994 Official Scenario</u>					
<u>Selected Economic Indicators</u>					
GDP growth	2.5	3.4	3.0	3.0	3.0
Interest rate on 5-year Swedish bonds	9.0	9.3	7.0
<u>Public sector (percent of GDP)</u>					
Financial balance	-11.1	-8.7	-6.0	-4.3	-0.9
of which:					
Primary balance	-4.1	-2.5	0.9	2.4	5.2
Revenue	58.7	59.1	59.6	60.0	60.5
Expenditure	69.7	67.8	65.6	64.3	61.4
Gross debt	92.2	95.7	96.6	95.8	91.6
<u>Assumed cumulative budget saving measures (in billions of SKr)</u>					
	--	35	55	75	95
<u>II. January 1995 Official Scenario</u>					
<u>Selected Economic Indicators</u>					
GDP growth	2.0	2.6	2.9	2.7	2.7
Interest rate on 5-year government bonds	9.1	10.0	9.3	8.0	7.5
<u>Public sector (percent of GDP)</u>					
Financial balance	-11.2	-10.2	-6.8	-4.8	-2.4
of which:					
Primary balance	-3.9	-2.5	1.1	3.9	6.1
Revenue	59.4	60.3	60.6	61.6	62.0
Expenditure	70.6	70.4	67.4	66.4	64.4
Gross debt	...	99.1	102.7	103.1	101.3
<u>Assumed cumulative budget saving measures (in billions of SKr)</u>					
	...	25	45	72	92

Sources: Sweden's Economy, November 1994 and January 1995; and staff estimates.

1/ See Appendix I of the Staff Report for a discussion of the November 1994 Scenario.

Table 2. Sweden: Selected Economic Indicators

(Percent change, unless otherwise noted)

	1990	1991	1992	1993	Official projections 1/		
					1994	1995	1996
<u>Real domestic demand</u>	<u>0.9</u>	<u>-2.1</u>	<u>-2.2</u>	<u>-4.9</u>	<u>1.1</u>	<u>1.4</u>	<u>1.8</u>
Public consumption	2.6	3.2	-0.6	-0.7	-0.2	--	-1.0
Private consumption	-0.1	1.1	-1.9	-3.8	0.6	--	1.0
Gross fixed investment	0.7	-8.4	-11.0	-16.2	-1.3	9.5	8.5
Stocks 2/	0.2	-1.7	1.3	0.3	1.0	--	0.1
<u>External balance 2/</u>	<u>0.4</u>	<u>1.0</u>	<u>0.3</u>	<u>2.9</u>
Exports of goods and services	1.9	-2.4	2.2	7.2	12.2	9.5	7.3
Imports of goods and services	0.7	-5.0	1.3	-0.4	11.0	7.0	5.0
<u>Real GDP</u>	<u>1.4</u>	<u>-1.1</u>	<u>-1.9</u>	<u>-2.1</u>	<u>2.0</u>	<u>2.6</u>	<u>2.9</u>
<u>Inflation</u>							
Consumer price index	10.5	9.3	2.3	4.6	2.2	2.9	3.7
Net price index 3/	6.8	5.5	4.2	4.3	1.4	1.8	1.8
<u>Earnings and employment</u>							
Average earnings 4/	9.2	4.7	4.7	3.2	3.0	3.3	...
Employment	0.9	-3.0	-4.1	-5.5	-0.9	2.7	1.8
Open unemployment (as percent of labor force)	1.5	2.9	5.3	8.2	7.9	6.8	6.1
Labor market programs (as percent of labor force)	3.0	3.7	5.3	5.1	5.1	4.8	4.7
<u>Industry</u>							
Hourly labor costs	9.5	8.5	3.3	0.8	3.6	6.6	5.5
Productivity	1.5	0.9	6.9	8.9	3.8	1.9	2.8
Unit labor costs	7.9	7.5	-3.4	-7.4	-0.2	4.6	2.6
<u>Personal sector</u>							
Real disposable income	4.2	4.8	2.6	-3.8	1.4	-2.4	-0.5
Saving ratio 5/	-0.6	3.0	7.3	7.2	8.5	6.3	4.9
<u>External current account</u>							
<u>balance (as percent of GDP)</u>	<u>-2.9</u>	<u>-2.0</u>	<u>-3.1</u>	<u>-1.0</u>	<u>0.4</u>	<u>1.5</u>	<u>3.6</u>

Sources: Ministry of Finance; and National Institute of Economic Research.

1/ January 1995 Ministry of Finance forecast. Projections reflect revisions to the national accounts.

2/ As a contribution to GDP.

3/ Consumer prices excluding indirect tax effects.

4/ November 1994 forecast.

5/ As a percent of disposable income.

